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ARIZONA CORPORATION COMMISSION

April 24, 2003

Chairman Marc Spitzer
Commissioner Jim Irvin
Commissioner William Mundell
Commissioner Jeff Hatch-Miller
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Re: Docket No. G-01032A-02-0598, et al.
Proposed Unisource Acquisition Settlement Agreement

Dear Colleagues and Parties to the Docket:

This letter is to invite discussion of two policy issues that surround the Unisource Settlement Agreement. First, is the provision that calls for Tucson Electric Power to loan its parent company, Unisource, \$50 million to help acquire Citizens' Gas and Electric Divisions. Second, is a discussion of TEP's equity ratio.

TEP Loan to Unisource

The Unisource Settlement Agreement authorizes the New Companies to issue up to \$475M in debt. As shown in Appendix A, Sections A and B, the New Companies can issue up to \$250M in bridge financing, \$175M in bond financing and \$50M in revolving credit. These debts may be secured by the assets of the New Companies. The Settlement Agreement also authorizes the New Companies to acquire up to \$125M in equity from Unisource. (Unisource has issued an SEC filing providing notice of its intent to issue up to 4 million shares of common stock to finance the acquisition of Citizens Gas and Electric Divisions.) TEP is authorized to loan Unisource \$50M. Unlike the creditors whose loans are secured by the New Companies' assets, TEP's loan will be secured by 100% of the New Companies' equity. The value of the equity in the New Companies is unknown.

The purchase price for the Electric Division is \$92M and the Gas Division is \$138M. Citizens appears to have assets valued at \$219M.

I have not decided or come to any opinion on the matters presented in the Citizens dockets or the proposed Settlement Agreement. I do, however, have concerns over the issues presented in this letter. I ask the parties to address these questions in the hearing that begins on May 1.

What are the policy implications of a regulated utility loaning money to its parent company in exchange for an interest in a third company where the value of the security is questionable?

How do ratepayers benefit from a TEP loan to Unisource? What risks are involved?

How will TEP's \$50M loan to Unisource affect TEP's liquidity? Will TEP have to borrow the money in order to lend it to Unisource? If so, is this loan inconsistent with the policy found in FERC's February 21, 2003 Order in Docket No. ES02-51-00 relating to the issuance of debt by a regulated utility for non-utility purposes? If TEP does not have to borrow money to loan \$50M to Unisource, how will the reduction of TEP's cash-on-hand affect its financial health?

Could TEP guarantee a \$50M loan by Unisource? What benefits does a guarantee provide?

Since the purchase price is \$230M and the Settlement allows the New Companies to borrow up to \$475M and Unisource is providing \$75M - \$125M in equity, why couldn't Unisource acquire Citizens Gas and Electric Divisions without TEP's financial assistance?

Graduated Equity Ratio

In 1997, this Commission authorized the creation of Unisource (Decision No. 60480). Unisource receives dividends from TEP earnings. In Decision 60480, as modified by Decision No. 62103 (1999), the Commission required TEP's equity ratio to be at least 37.5% in order for Unisource to receive dividends from TEP's full earnings. If TEP's equity ratio fell below 37.5%, Unisource could receive dividends only from 75% of TEP's earnings. TEP's equity ratio is reported to be 23%.

The Settlement contains a similar provision with regard to the New Companies. They must have an equity ratio of at least 40% in order for Unisource to receive dividends from their full earnings. If the equity ratio is less than 40%, the dividends come from 75% of the earnings.

Does the current restriction on dividend receipts sufficiently encourage a parent company to increase the equity ratio of its subsidiaries? Specifically, since TEP is below 37.5% equity, what incentive is there to increase its ratio unless that effort brings it above the 37.5% benchmark? Alternatively, since Unisource receives dividends on 75% of the earnings if TEP's equity ratio is 35%, 25% or even 15%, what incentive does Unisource have to prevent TEP's equity ratio from falling?

Should the Commission consider implementing a graduated dividend structure to encourage a parent to increase the subsidiary's equity ratio? For example, if a subsidiary's equity ratio fell below 25%, the parent company would receive dividends from 60% of the earnings. If the ratio fell below 15%, the parent would receive dividends from 30% of the earnings. Would such a graduated structure provide an incentive to maintain as high an equity ratio as possible?

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Generally, does a higher equity ratio produce a financially healthier utility which, in turn, allows it to have increased operating funds, incur loans at a lower interest rate and to be better prepared for any unexpected occurrences in the market thus protecting the rate payers?

I look forward to receiving your responses to these concerns during the hearing.

Sincerely,

A handwritten signature in cursive script, appearing to read "Mike Gleason".

Mike Gleason
Commissioner

c: Parties to the Docket